MASTER LIMITED PARTNERSHIP MYTHS

Having worked with MLP investors for a decade, we receive many questions from clients and prospects about the asset class. Now that MLP investing has entered the mainstream, we often find "myths" about the MLP sector in news articles and various media outlets. Here are some of the more common ones.

1. *There is nothing unique about MLP investments as opposed to other stocks.*
   Not true. Unlike most public companies, MLPs are partnerships. As a result, MLPs only pay one level of US federal income tax and are not subject to double taxation experienced by public corporations. In addition, MLPs typically pay out cash distributions every quarter. Investors receive a Schedule K-1 at year's end, instead of a Schedule 1099.

2. *MLPs are illiquid investment vehicles just like private partnerships.*
   Not true. Most MLPs are traded on active markets just like any publicly traded company. Many MLPs trade on the New York Stock Exchange.

3. *There are few publicly traded MLPs.*
   There are 125-plus MLPs that are traded on the NYSE. Argyle's investment universe comprises approximately 20 publicly traded energy-related "midstream" MLPs. We cherry pick companies based on market cap, distribution history, distributable cash flow metrics and sector, for example.

4. *All MLPs are pipeline companies.*
   Not true. MLPs are classified by location in the energy supply chain. Upstream MLPs include companies that acquire and produce oil and natural gas; these are often referred to as Acquire and Develop (A&D) companies.

   Midstream MLPs gather, process, transport, and store oil, natural gas, and refined petroleum products. Their role is to move the products from the E&P companies to the downstream companies that refine, market, and sell to the end user. (A local gas company that services homes and businesses is an example of a downstream company.)

   Other energy MLPs work in coal leasing and mining, marine transport of petroleum products, and crude oil refining/distribution of refined products (i.e. gasoline).

5. *All MLPs are sensitive to oil prices.*
   Many MLPs, such as the midstream companies do not take title to commodities. Although some companies' results are directly correlated to oil and gas prices, most MLPs' businesses are influenced more by the commodity volume they handle. This is a testament to the utility-like nature of a business model built on conservative balance sheets, long-lived contracts and geographic monopolies. Whether the commodity being transported via MLPs are high-priced or low-priced, the toll captured is the same.

6. *MLPs, like REITs, have to distribute 90% of their pretax earnings, in cash, to investors.*
   Not true. There is no rule that MLPs must distribute any percentage of their income. In more recent years, there have been several MLPs that have reduced or eliminated

distributions due to the economic environment. However, those that tend to perform well over time show a consistent increase in their quarterly distributions.

7. *MLP distributions are taxed as ordinary income.*
   One appealing feature of an investment in MLPs is the income tax-deferred treatment of quarterly cash distributions. The majority of distributions are considered a "return of capital" and a reduction to the cost basis, thus these are not taxed when received. A small portion of other income (interest and dividends) may be considered ordinary income, typically about 2%-7% of the total distribution. MLPs create a tax shield through required allocations of depreciation, depletion and special tax basis adjustments for the public investor. When an investor sells his or her interest in an MLP, a portion will be a capital gain or loss and a portion may be ordinary income. The extent to which the gain upon a sale is capital versus ordinary depends on a number of factors related to that particular MLP. Since cost basis reductions may be meaningful over time, it is important to note that basis steps up on death. As such, MLPs can make a great Estate Planning vehicle.

8. *ETN (Exchange Traded Notes, ETF (Exchange Traded Funds) and CEF (Closed-end funds) have the same tax benefits as a Separately Managed Account (SMA) investor in MLPs.*
   Closed-end funds and C Corp vehicles save investors the administrative details of K-1 filing but they pay taxes at corporate levels. Normally these funds use leverage and illiquid securities, and are often very expensive (total annual costs of 3-5% including margin interest are not uncommon). Most closed-end funds reduced their distributions in 2008, a year which nearly all MLPs raised their payouts.

   ETNs, which issue a 1099 for income paid out each year, are not tax advantaged. All ETN distributions are interest income and are taxed as ordinary income at each investor's tax rate. The credit rating of the ETN issuer needs to be considered. ETFs have similar tax treatment as closed-end funds.

9. *Schedule K-1s, issued to MLP investors at tax time, are lengthy cumbersome documents provided so late each year that investors need to file tax extensions.*
   MLP K-1s are generally sent to the investor in a timely manner in the middle to end of February each year. However, some MLPs that have depletion or year-end mergers lag in reporting their results. Thus these MLPs issue K-1s during the early part of March. The majority of MLPs provide investor tax packages online and these documents can be easily downloaded. At Argyle, this is something we handle on behalf of clients in coordination with their CPAs.

10. *MLPs issue new units through capital offerings, both public and private, or receive new proceeds through debt offerings. This may have a negative impact on current equity positions.*
    MLPs issue new units and bonds to finance new growth projects. New capital can be a leading indicator of rising future distributions for all unit holders. Assuming new capital is effectively deployed; the equity or debt cost of capital should be less than newly generated returns from that capital. US businesses

sometimes raise new capital to expand operations. This is nothing unique to the MLP market.

11. *MLPs are in danger of having their tax-deferred status changed.*
The MLP tax-deferred status has been in place since the mid 1980s. Some legislation has focused on taxation of general partners in financial asset-management businesses. Some proposed legislation focused on the performance of services by a partner, mostly through their management of the financial fund. More recently, Treasury staff discussed a proposal that would consider taxing some partnerships (including MLPs) with more than $50 million in "gross receipts" as corporations. However, House Ways and Means Committee Chairman Dave Camp, when asked about the proposal, threw cold water on the idea, saying "It's not something I'd be inclined to consider." At this moment, reasonable belief indicates that the proposal has no political or economic backing. This proposal would not impact MLPs, but every professional, financial, real estate, corporate joint venture and almost every aspect of the US economy.

Since the inception of the MLP enabling legislation in 1985, the MLP business/tax structure has been largely untouched by numerous political administrations and fiscal regimes. We believe that energy related MLPs will continue to play a vital role in US energy independence and, given the current political climate, should retain their current tax status.

12. *MLPs are similar to US Royalty Trusts and Canadian Income Trusts.*
This is a misperception. Resource oriented Canadian Income Trusts (CITs), somewhat similar to US MLPs, ceased to exist (by law) on January 1, 2011 having been a popular income vehicle since about 2000. Many of the CIT entities reverted back to C-corp structures while retaining a high payout model.

Royalty Trusts are passive owners of resources…oil, gas, minerals and timber. These Trusts are dependent on the lessee of the Trusts' resources to invest capital to monetize the resources. Trusts typically receive a royalty (% of the selling price) of the ultimate resource sold. Thus, Trust distributions can be highly variable due to fluctuations in both commodity prices and volumes sold.

The US MLP structure has been in place since 1985 and, unlike the Royalty Trusts, are actively managed by their executive teams with the primary goal of prudently growing distributable cash flow on a consistent basis.

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